Regions Wealth Podcast

Episode 3: Footing the Bill for Family

You know what combination gets complicated really fast? Money and family. Should you invest in your cousin's startup? Pay your mother's rent? What about your kids' college tuition or a down payment? Private Wealth Management Regional Executive Lee Blank joins us in studio to discuss the implications of lending money to a loved one, and what you can do to protect yourself before financing your family.

Episode Transcript

Anne Johnsos:
Welcome to Regions Wealth Podcast, the podcast that tackles life's challenges with financial experience. I'm your host Anne Johnsos. You know what combination gets complicated really fast? Money and family. Should you help fund your cousin's start-up? Pay your mother's rent? What about your kids' college tuition or a down-payment? Joining me in the studio is Lee Blank. He is a Market Executive and Regional Private Wealth Executive with Regions. Lee thanks for joining us.

Lee Blank, Private Wealth Management Regional Executive, Regions Bank:
It's my pleasure to be here. Thank you for having me.

Anne:
In this episode we are talking about footing the bill for family. We've taken frequently asked questions from a bunch of people and developed a character who needs your advice. Let's listen.

Sara Beth:
Hi there, I'm Sara Beth. I'm 68 years old and a widow. And I'm here today to talk to you about my 40-year-old nephew, Holden.

We had really high hopes for Holden, but he hasn't been able to find a consistent career. He spent a few years in New York City working in real estate but that didn't pan out. Tough market, I suppose. Then he got married to a great girl. But that only lasted a few years — the marriage and the job. He lived in Europe for a while after that doing who knows what. Anyway, I'm off on a tangent. What we really need to talk about is his company. He approached me a few years ago about how he'd finally found his passion. He wanted to design men's accessories — socks, bowties, and the like. He had a bunch of designs and patterns that he was sure would sell. He showed me a bunch of folders and basically wanted me to invest. He was asking for about $5,000. He said the manufacturers needed that much right away to get started. He offered me a stake in the company but didn't say anything about how much it would be, or when he saw me making my money back. I know it seems kind of fishy. But at the same time, I had the money. He's the closest thing I have to a son, and I'd never seen him this excited about something. So I gave it to him. I didn't even have him draw up papers.

Anne:
So Lee, how often do you hear about families asking for money from each other?

Lee:
Well interestingly enough it's probably the number one way that small businesses start. I mean you can look at the statistics, but family and friends are how many small businesses get started, so it's not unusual to approach a family member to participate in a new business.

Anne:
In fact, to reiterate what you just said, according to the U.S. Chamber of Commerce 30% of entrepreneurs use money from friends and family to fund their start-up. So, what metrics do you recommend for people deciding whether or not to ante-up? So if Sara Beth is looking at her nephew, what should she be looking at in terms of if it's worth it?

Lee:
Well I think generally with a family member you need to understand: did they know the business they are getting into? Did they have a plan? Have they thought it through or are they just taking a wing and a prayer? And really just asking a few simple questions about "do you have a plan? How do you propose to do this business?" — just simple questions. And then just sit back and listen and you will learn a lot, and figure out whether they really do have a course of action or they are just out there trying something new.

Anne:
Sara Beth says there was no paper, there was nothing, there was no promise about when to get it paid back. How formal should these arrangements be between family members?

Lee:
The way I always like to approach it is: do you still want to have Thanksgiving dinner with them? And the best way to think about that is if you want to make it an investment and take the personal relationship out of it so that you can still be family. It's better to put it on paper even if in your heart you know this is probably not going to work out. It will at least give you a separation between that event and being a family because generally — money and families — that's probably one of the number one problems we face as individuals.

Anne:
What would you put on that paper?

Lee:
I would put on the paper that: 1) I've made the agreement that I've invested this money. 2) What is the expectation for that money either being an investment or a loan? Because a loan, what are the repayment terms, how is that money going to be repaid to me, or if it's an investment how long will this investment be, what my return could be if it succeeds, and then what happens if it doesn't succeed? I think which is — anything you would do in a normal business agreement if you came to the bank for a loan — we're going to address all of those questions and it's better to have that in writing. Again, it tries to remove the emotion so that you can be family and good business partners.

Anne:
That's a good point about clarifying whether it's an investment or a loan. Explain the difference in terms of the impact on you, as the person putting in your money.

Lee:
The difference between an investment and a loan is an investment is ownership in the company. That means you have a stake in the company, and you are repaid when that company either sells or some transaction occurs with the business. A loan is money that is given to the company to purchase something — inventory, equipment — and you have a specified plan for the repayment of that loan with an interest rate, monthly payment and a time commitment that the loan will be paid in full.

Anne:
So, would Sara Beth ask different types of questions of Holden if she's thinking her contribution is going to be an investment versus a loan?

Lee:
I think the questions either way would be the same because I think that would be what you would want to do in order to determine it. I think it would be: what is your plan? How are you going to accomplish your plan? How are you going to manage your finances and what do you see this business in a year, three years, five years? And just really more ask questions to see 1) how committed he is to the idea; does he really have a plan, and does he have a way to make it happen?

Anne:
So Sara Beth is retired. Should that factor into her decision to help him?

Lee:
Definitely. I mean, she is in a position where she's not generating new income, she's just living on what she's accumulated. Now she may be blessed to have enough resources to be able to do that, but in order to be prudent you still need to have a plan and it's good for the other individual to hold them accountable and see what they're made of.

Anne:
Alright, so now we're going to hear what happens next.

Sara Beth:
So it's been a couple of years now. I'm a little concerned by the fact that Holden hasn't discussed repayment yet. I've seen some of his merchandise. He's got a website and I saw some of his socks at a boutique in Raleigh last year, so I know it's a real business, but I'm having a hard time seeing how he's making any money from this. He bought a brand-new Mercedes last year so he must be doing okay.

Anne:
So, a 2009 survey by CNN Money reported 27% of people who lent money to family or friends didn't receive anything back and 43% were not paid back in full. So when it comes to these types of loans, how should repayment be handled?

Lee:
The best scenario is always to have it down on paper on the front end, but as we've seen with Sara Beth and many, many other family members, that's not the case.

I think in this case Sara Beth should just sit down with her nephew and say, "I've seen that you've had some success. I've seen how great you've done. I've seen your socks in Raleigh. I've seen your socks on your website. I also see you're driving a new car so congratulations on the success. I would really like to sit down and understand about how my initial investment or loan with you how we're going to work out our arrangements to have that repaid." And then just kind of be quiet and listen.

Anne:
Sara Beth didn't draft anything to begin with, but should she be looking for updates or looking at the books? Should she be looking for reports from Holden as to how the business really is doing?

Lee:
Yeah. I think especially since there wasn't that much formality at the beginning of it, now is the time to establish that. And part of it is, "hey, I've seen your success, seen what you're doing. I would like to kind of understand how the business is going." Many small businesses don't do formal accounting, so bank statements are a great way to see it. Or there are tax returns. If they are filing as a sole proprietorship or if they are filing as a small business as a corporation and however they structured the business, there will be a tax return and that's probably the most beneficial way to see what's going on in the business. And if you are probably Sara Beth, you haven't spent a whole lot of time looking at those, so that's where I would ask my advisor to look at it and tell me what you're seeing.

Anne:
OK. So let's listen to this next bit.

Sara Beth:
Now he's asking me to invest more money. This time he's saying $20,000 and he does actually have paperwork. He says it's for a 5% share, but I have no idea what to make of it. I don't know if the numbers he's showing me are legitimate and it's all starting to feel a little weird. I would like a bit of guidance but I'm hesitant to approach our family lawyer about this.

Anne:
Ooh. Okay. So, Lee, what's your initial reaction to this new request?

Lee:
There is something weird there. If he's bringing a document that asks for $20,000 and it's worth only 5%, I would want to understand I'm getting 5% of what? I need to understand your financial situation. How this investment is going to be important to the business and what you expect from this investment, and more importantly what does it mean for me?

Anne:
When he asks for this $20,000 and then promises a 5%, what should she be asking to see to prove what the business is worth?

Lee:
That is where you've got to see the financial information. You've got to see what would be a balance sheet and an income statement. Those are the two primary things. The income statement will show you how much revenue they are generating, what the cost of generating that revenue, and what the profits are in the business. And then the balance sheet will show you what the inventory, what the cash on hand is, whatever other debts he may have, and really show you what the value of the company is. So the income statement is all about what's happening from what we would say is the cash flow, the operations of the business and the balance sheets, kind of the outcome, what does it look like from a valuation standpoint.

Anne:
Should she be asking to see or talk to other investors?

Lee:
That would be a great question. Who else is investing in your company? If this is 5%, who's got the other 95%, and what's the value of those shares or their ownership versus what you're asking me to do? So that's a very good question.

Anne:
So how might taxes play into a $20,000 loan or investment?

Lee:
That's a great question. You know if it's an investment then you establish what would be called a cost basis, so the value of your investment when you first make it is $20,000. Everybody hopes it's going to go up and you make a whole lot more money. But the other side is if it goes bust then you've lost $20,000, and if it's formal you can take a $20,000 loss on your taxes. The business would lose and just go out of business. If it was a loan and the loan is not repaid, that's where the borrower would then — if it's a sole proprietor specifically — he would end up having $20,000 of income that the IRS would say he got because he didn't repay the loan. So yes, there are tax implications whether it's an investment or a loan.

Anne:
With a $20,000 loan or investment and a 5% share in the company, should Sara Beth have any expectation of shaping the company's growth or trajectory?

Lee:
At 5% you don't have much influence. That's why you really need to know what percentage value that $20,000 is of the entire company. Because you may find out it's 51 or 52% and then in that case you should have a whole lot of say and should expect to have a whole lot of say. So that's why it's important to really understand what your contribution or what your investment is and how it relates to the overall ownership of the company.

Anne:
At the end of this she says, "I would like a bit of guidance but I'm afraid to, or hesitant to approach the family lawyer." Is this a good time to get that lawyer's advice or a financial advisor?

Lee:
Definitely. I would just swallow my pride a little bit and go in and tell my story because I guarantee you that advisor has seen this exact scenario many times and they will be able to help you think through it and work through it. So I think it's most prudent to go ahead and have that conversation.

Anne:
At the end of these podcasts, we like to offer some takeaways for our audience, something they can tell their friends. So, what are some takeaways for Sara Beth or for anyone listening?

Lee:
I think the first thing is, is you need to go into it as "is this money I expect to get back?" That's the first question you need to ask yourself and then the next question you need to ask is "how is my money going to be used and how do you intend to repay me?" I think that's the second one. And then the third is involving someone as it gets more complicated as a third-party intermediary so that you can remain family.

Anne
Thanks so much for that insight, Lee. I'm sure for people who recognized themselves in Sara Beth's story, it's nice to know this is a tricky situation for a lot of people, but there are things you can do to protect your money and your relationship.

Anne
And thanks to all of you for listening. Every episode is a new story with new insights from ~~a~~ Regions advisor. We hope you'll continue to tune in and share us with a friend who might enjoy Regions Wealth Podcast.

Anne:
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